



OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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Chief Administrative Officer

September 9, 2009

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended June 30, 2009. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees and employees who elect to participate in the Guaranteed Retirement Income Plan (effective July 1, 2009). There were approximately 4,825 active members and 5,560 retirees participating in the ERS as of June 30, 2009.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 11.37%, 28 basis points behind the 11.65% gain recorded by the policy benchmark. For the one year period ending June 30, 2009 the ERS' gross return (before fees) was a loss of 15.81%, 23 basis points behind the 15.58% loss recorded by the policy benchmark. The one-year return, after fees, places the ERS' performance in the top 10% of a universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was a loss of 0.98%, after fees, also ranking in the top 10% of the universe. The asset allocation at June 30, 2009 was: Domestic Equities 28.2%, International Equities 19.3%, Fixed Income 28.6%, Inflation Linked Bonds 10.1%, Commodities 3.3%, Private Equity 6.4%, Real Estate 3.7% and Cash 0.4%. We estimate that the funded status of the ERS was 80.6% as of June 30, 2009, an increase from 78.6% at March 31, 2009. The actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

Major Initiatives

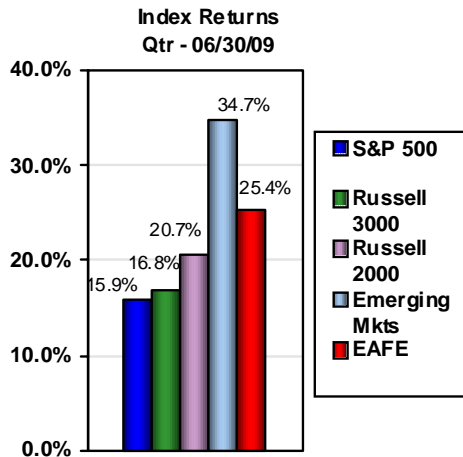
During the quarter, the Board approved the private equity commitment pace of approximately \$60-\$70 million per year to reach the ERS' target allocation of 10% by 2012 with no new monies being committed to venture capital in 2009 except via previous commitments to fund-of-fund managers. Within the private equity sector, the Board approved an investment of \$12,000,000 in the TA Associates XI LP. In addition, the Board received an update on the Risk Management Program, including a demonstration of the risk budgeting tool which Staff uses to evaluate total plan risk and the contribution of alpha from and the risk used by the underlying managers.

Capital Markets and Economic Conditions

Stronger than expected economic reports continued to emerge during the quarter, particularly within the manufacturing and housing sectors, sending global stock markets higher (the S&P 500 Index recorded a 15.9% gain, the largest quarterly return since 1998). Though down 18.1% versus one year ago, and roughly 30% off from their May 2006 peak, home prices continue to fall but at a slower rate. Both single family housing starts and permits are up since the beginning of the year. However, while overall financial conditions have eased, household credit conditions have not. Consumer spending is estimated to have

declined by about -0.5% during the quarter despite a huge boost to disposable income from fiscal stimulus packages, such as “cash for clunkers.” Much of the stimulus boost has apparently been saved by consumers as the savings rate stood at 6.9% in May 2009, up from 0.1% in January 2008.

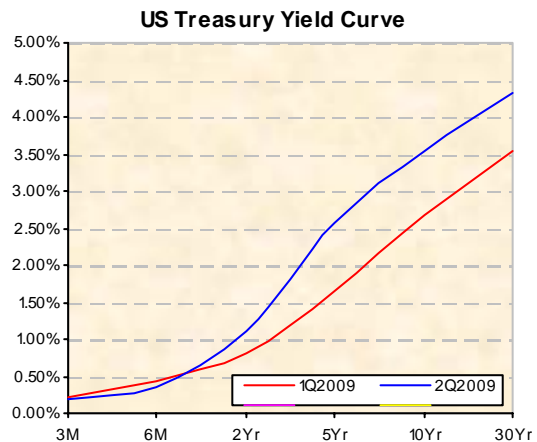
Public Equity Markets: The U.S. equity markets posted strong positive returns after six consecutive negative quarters, with the S&P500 recording its largest gain since 1998. The stock market rally that



dominated the early part of the second quarter was due to worldwide government measures mitigating the crisis in the financial sector and various economic reports showing signs that the economic contraction was slowing. As shown in the chart to the left, smaller capitalization companies (Russell 2000 Index) outperformed their larger counterparts (S&P 500 Index) in the U.S. All sectors of the S&P 500 posted positive returns during the quarter, with financials, IT, and industrials performing the best. Our combined domestic equity performance was a gain of 17.13%, 31 basis points ahead of the Russell 3000 benchmark. For the one year period ending June 30, our combined domestic equity portfolio recorded a loss of 27.24%, trailing the benchmark's 26.56% loss by 68 basis points.

Within the international equity sector, developed markets, as measured by the MSCI EAFE Index, were up 25.43% for the quarter, compared to emerging markets which advanced 34.73%. All EAFE markets were up with Singapore (+46%) and Greece (+39%) recording the strongest performance. The markets of Hungary (+70%) and India (+60%) took the lead within the emerging markets sector. Our combined international equity performance was a gain of 27.71% (26.78% after including the negative performance of our currency managers) for the quarter, 12 basis points ahead of the benchmark's gain of 27.59%. For the one year period ending June 30, our combined international equity return was a loss of 23.36% (22.95% after including the currency managers), outperforming the benchmark by 756 basis points.

Fixed Income: The Federal Reserve Board kept the Fed Funds target range at 0% to .25% in anticipation that economic conditions are likely to warrant the low range for an extended period of time. The yield curve steepened (shown in the chart below) as the 2 year Treasury bond rose 32 bps from 0.80% to 1.12% and the 30 year Treasury bond rose 79 bps from 3.54% to 4.33%. Treasuries were out of favor, recording their worst total return in over a decade and credit spreads tightened to levels not seen since before the Lehman bankruptcy. The high yield bond market, represented by the Merrill Lynch High Yield Master II Index, recorded one of its best quarters on record, up 23.10%. Long investment grade credit issues also rallied amid improving fundamentals, positive investor sentiment and attractive yields. Our combined fixed income performance for the quarter was a gain of 8.18%, outperforming the 6.58% gain recorded by the benchmark index. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 0.35% for the quarter, compared to the 1.69% return of the benchmark.

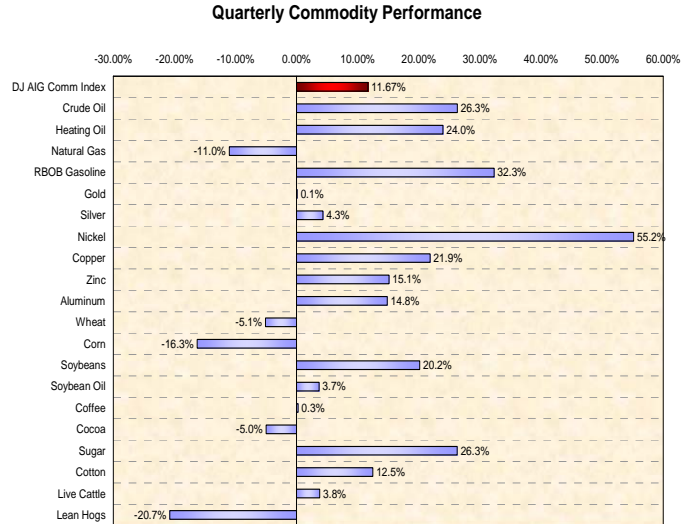


Private Equity: The second quarter saw improved, albeit still slow, transaction activity. In buyouts, mostly smaller deals are getting done – while transaction volume is down 25% year-over-year, the total dollar value of activity is down more than 75%. Within the venture capital sector, early stage investing saw a healthy quarter-over-quarter pickup in activity as did investments in life sciences. Transaction activity will likely remain suppressed until there is additional clarity on the timing of the hoped-for economic recovery. During the quarter, our private equity managers called a combined \$5.6 million and paid distributions of \$0.2 million. Our current allocation to private equity is 6.4%, with a market value of \$136.9 million.

QUARTERLY REPORT

Private Real Assets: Real estate and natural resources investments continue to reflect the weakness of the overall economy. Real estate rental rates and occupancies are decreasing, while resource production rates are also running at lower levels as equipment is brought offline. Transaction activity in private real assets is down significantly year-over-year, though only slightly versus the previous quarter. During the quarter, our managers called a total of \$2.8 million and paid distributions of \$0.3 million. Our current allocation to private real assets is 3.8%, with a market value of \$79.9 million.

Commodities: After a severe correction over the last three quarters, the commodity markets experienced a powerful rebound this quarter, led by the strong performance of the Metals and Energy sectors. Base metals rallied as demand from China drove nickel (+55%) and copper (+22%) to nine month highs. Within the Energy sector, crude oil and gasoline posted gains of 26% and 32%, respectively. Among the other markets, sugar rose on a projected shortage in crop estimates for certain countries, especially India. In contrast, the pork-related markets fell strongly on swine flu headlines. During the quarter, our commodities portfolio advanced 14.57%, outperforming the DJ UBS Commodities Index by 290 basis points.



Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending June 30, 2009 and fiscal year-to-date.

Employees' Retirement System

Contributions and Investment Income (millions)

	Qtr 6/30/2009	Fiscal YTD
Employer Contributions	\$ 28.0	\$ 109.6
Member Contributions	4.7	18.2
Net Investment Income (Loss)	215.7	(423.3)
	<u>\$ 248.4</u>	<u>\$ (295.5)</u>

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System

Deductions by Type (millions)

	Qtr 6/30/2009	Fiscal YTD
Benefits	\$ 40.6	\$ 168.6
Refunds	0.1	0.5
Administrative Expenses	0.9	2.8
	<u>\$ 41.6</u>	<u>\$ 171.9</u>

Outlook

The second quarter data suggests the pace of contraction in real GDP growth slowed from the previous six months. If demand stabilizes at the current level, the remainder of 2009 should benefit from an increase in production as firms work to meet new order demand. Inventories are extremely lean now across a range of industries, especially in autos. However, consumer spending remains sluggish. Employment income remains severely depressed and will remain so until the unemployment rate begins to fall. Household balance sheets have been impaired by diminishing housing and equity wealth. Moreover, energy prices have risen from their lows. As a result, the growth rate of consumption over the next year or so will likely be modest when compared to past recoveries.

Although there has been recent talk of the Federal Reserve's "exit strategy" from monetary stimulus and quantitative easing, this is probably a bit premature given the continued job losses. Historically, the Fed has waited for improvement in the labor markets before restricting the supply of credit. On the inflation front, given the level of excess capacity, weak consumer spending, and the continued rationing of credit by banks, inflation fears over the near term seem unwarranted. The core CPI is well below the top of the Fed's implicit target range of up to approximately 2%.

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS**
June 30, 2009

Assets

Equity in pooled cash and investments	\$ 494,666
Investments:	
Northern Trust	2,257,083,318
Aetna	13,950,576
Fidelity - Elected Officials Plan	684,504
Fidelity - DRSP	1,282,001
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Total investments	2,273,000,399
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Contributions receivable	8,584,309
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Total assets	2,282,079,374
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Liabilities

Benefits payable and other liabilities	130,694,210
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Net assets held in trust for pension benefits	\$ 2,151,385,164
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EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
June 30, 2009

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 28,040,365	\$ 109,567,013
Member	<u>4,716,377</u>	<u>18,244,976</u>
Total contributions	<u>32,756,742</u>	<u>127,811,989</u>
Investment income (loss)	218,856,219	(410,605,772)
Less investment expenses	<u>3,124,268</u>	<u>12,669,404</u>
Net investment income (loss)	<u>215,731,951</u>	<u>(423,275,176)</u>
Total additions (deletions)	<u>248,488,693</u>	<u>(295,463,187)</u>
Deductions		
Retiree benefits	29,359,398	123,560,072
Disability benefits	9,355,418	37,724,912
Survivor benefits	1,864,032	7,333,268
Refunds	126,817	503,635
Administrative expenses	<u>880,758</u>	<u>2,831,201</u>
Total deductions	<u>41,586,423</u>	<u>171,953,088</u>
Net increase (decrease)	<u>206,902,270</u>	<u>(467,416,275)</u>
Net asset held in trust for pension benefits		
Beginning of period	<u>1,944,482,894</u>	<u>2,618,801,439</u>
End of period	<u><u>\$ 2,151,385,164</u></u>	<u><u>\$ 2,151,385,164</u></u>